Islamic Finance: Introduction and Implications for Future Research and Practice

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In our continuous and relentless endeavor to advance research in the field of Islamic finance, we present this supplement, following a highly successful one in 2014 (Abdelsalam and El-Komi 2014). This special issue expands the horizon of research on Islamic finance. For the first time, we see a good number of articles on behavioral finance and its implications for Islamic finance. Furthermore, there are now a couple of papers on financial inclusion and one paper on sovereign debt. In addition, we continue to present papers on the performance of Islamic financial institutions and capital markets.

The behavioral finance papers in this supplement deal with a number of issues. Azmat et al. (2016) explains why Islamic finance instruments that are based on risk-sharing (i.e. *Musharakah / partnership)* are less attractive in the eyes of the Muslim investor in comparison to debt-based instruments (e.g. *Shariah* compliant bonds). They adopt an empirical methodology by analyzing data on: Islamic bonds (*sukuk*) from the Dow Jones Sukuk Total Return Index (DJSTRI); Islamic equities, from the Dow Jones Islamic Market World Index (DJIMKT); and simulated data on *Musharakah* instruments. They found that *Musharakah* instruments are crowded out by Islamic debt bonds for shorter evaluation periods and by Islamic equities for longer evaluation periods on two grounds. The authors explain this crowding-out effect with reference to two behavioral attributes: myopic loss aversion and habit based utility. Berg et al. (2016), however, explain the existence of different Islamic finance products in the market by basing it on the *Shariah* stringency of such products. They, theoretically, explain this market segmentation of Islamic finance products, which are priced differently by a signaling mechanism. According to their model, the Shariah Boards of Islamic Finance Institutions have an incentive (ceteris paribus) to choose different degrees of religious stringency in order to attract different types of pious clients. Accordingly, clientele with distinct group identities are willing to pay different premiums to signal their distinct piety types.

The effect of investor mood on herding is investigated in Gavriilidis et al. (2016), in which they link positive moods during Ramadan to herding behavior. Positive moods and enhanced social interactions during Ramadan render investors less risk-averse, and hence, more prone to herding behavior. The paper analyzed a sample of seven stock markets from Muslim majority countries to find a significant presence of herding during Ramadan. Ramadan was also the topic of interest for Mazouz et al. (2016), who looked at events that are entirely information-free, following the additions and deletions of stocks from Dow Jones Islamic Market World Index (DJIMWI). According to Mazouz et al a stock's comovement with DJIMWI increases

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when joining and decreases when leaving. The magnitude of such comovements increases, in the same direction during Ramadan and during periods of high trading activities of the stocks' local indexes.

Abdeifar et al. (2016) and Mertzanis (2016) discuss financial inclusion. The former finds the Islamic banking market share to have a positive effect of on the development of the financial system in a sample of 22 Muslim countries. The latter investigates the factors that affect firms' access to finance and performs a comparison between Muslim and non-Muslim countries by analyzing a sample that includes 42 Islamic countries and 37,455 firms.

Capital markets are discussed in three papers, which offer new perspectives on *Sukuk* and *Shariah* screened portfolios**.** Godlewski et al. (2016**)** analyze the stock market reaction (abnormal returns) of a sample of Sukuk[3] issuance over a period of 8 years. Results show a positive impact on the issuing companies' share price from issuing 'Ijarah' (lease) Sukuk and from the reputation of the Shariah Scholars who certified the Sukuk. Both factors are related to the Sukuk's Shariah compliance. Ijarah Sukuks remained largely non controversial in the 2008 Sukuks' shariah compliance crisis. The reputation of the scholar also remains crucial for the Sukuks' Shariah compliance. The other two papers deal with Shariah screened portfolios. Ashraf and Khawaja (2016) compare the performance of market-weighted Shariah-compliant portfolios with conventional counterparts from five regions: USA, Canada, Europe, the GCC, and Japan. Using the five Shariah screening criteria as proposed by MSCI, FTSE, Dow Jones, S&P and AAOIFI, the authors constructed portfolios from constituent-level monthly price data. Their empirical results indicate that Shariah-compliant portfolios are generally less risky than their conventional counterparts. They also find that Shariah screening standards have an insignificant effect on the portfolio return performance. The second paper by Abdelkader et al. (2016) investigates the relationship and shock transmission between firm leverage and systematic risk of 689 firms in Shariah screened portfolios from seven European countries. The study examined the impact of debt screening on moderating stock volatility risk and susceptibility to contagion. The study shows that Shariah screened stocks carry less systematic risk than conventional stock, while they do not necessarily out-perform in terms of return, especially during the global financial crisis.

Comparisons between Islamic financial institutions and their conventional counterparts are conducted in both this supplement and the previous one. Three papers perform such comparisons on Islamic banks and one paper does so for mutual funds. Sorwar et al (2016) analyze the market risk profiles using the Value-at-Risk (VaR) and losses beyond VaR (Expected Shortfall: ES). The study covers a period of 13 years from 2000 to 2013, which is classified into three intervals; pre, during and post the global financial crisis. Dynamic correlations obtained via a multivariate setting shows Islamic banks to be less risky than their conventional counterparts and, especially so, during the 2008 global financial crisis. Saeed & Izzeldin (2016) examines the relationship between efficiency and default risk in both Islamic and conventional banks in eight MENA countries over the period 2002–2010. Using the Stochastic Frontier Approach and distance to default

[3] Shariah compliant alternative to conventional bonds

(Merton's model) to find that a decrease in default risk is associated with lower efficiency levels for conventional banks, but not for Islamic banks, in the GCC. For Islamic banks, default risk was found to be inversely associated with efficiency. The third paper by **Abdelsalam et al. (2016)** compares the quality of earnings reported by Islamic and conventional banks in the MENA region during 2008 – 2013. Their study shows that Islamic banks are less likely to manage (manipulate) earnings and that they adopt more conservative accounting policies. The results support the contention that religious norms have a significant impact on financial reporting quality and agency costs, which have implications for both regulators and market participants worldwide. The last paper to compare Islamic financial institutions to conventional ones, in the case of mutual funds is El-Masry et al. (2016). It compares the performance of Islamic and conventional funds in the MENA region during crisis and recovery periods. The results show that the relative performance of Islamic and conventional funds seem to be dependent on the geographical context in which the investment is made. Islamic funds outperform conventional funds in the Gulf area but slightly underperform for the whole region. In addition, their study provides empirical evidence that Islamic funds are more stable in times of distress.

At the macro level, we have one paper in this supplement, by Onder (2016). This paper proposes that asset backed contracts, which are widely used in Islamic finance, could solve the lack of legal enforcement mechanisms in the case of sovereign default. In Asset backed contracts the usufruct over the assets transfer to the asset holder. As these contracts, are governed by international laws, the international assets of a country could be seized in the case of default. The study uses Argentina, as an example of a country that defaulted twice in 13 years. Had Argentina utilized asset backed contracts prior to its debt default in 2001, it would have had larger welfare gains, higher debt-to-GDP ratios, lower probability of default and lower borrowing costs.

Implications for Future Research and Practice:

The papers that appear in this special supplement create different implications for the future trajectories of research and practice in the field of Islamic finance.
Azmat et al. (2016) suggest extending their research by using a parametric approach to estimate the impact of different variables on the investor's choice of debt, equity and partnership (Musharakah) and to conduct experimental research on how religiosity influences these aspects of risk taking. Berg et al. (2016) also suggest experimental testing of their model of heterogeneous Shariah-compliance policies and market segmentation. They suggest conducting an empirical investigation to link the features of their model. Mertzanis (2016) provides empirical evidence that financial inclusion is still inadequate for small, introverted and non-manufacturing firms, operating at a distance from urban centers. Abedifar et al. (2016) provide empirical evidence that the presence of Islamic banks can foster access to finance and financial deepening, and thus improve economic welfare particularly in countries with a predominantly Muslim population, higher uncertainty avoidance index and a comparatively low GDP per capita.

Godlewski et al. (2016) advance our understanding of the types of *Sukuk* structure that

are favored by the markets, which might direct the evolution of Sukuk structure and their governance in the future. The empirical evidence, provided by Ashraf and Khawaja (2016) indicates that the differences in *Shariah* screening criteria have an insignificant effect on portfolio return performance, suggesting that a consensus of opinion from *Shariah* scholars could be quite plausible and will reduce confusion among the investing public. Furthermore, the empirical evidence presented by Abdelkader et al (2016) that debt screening is imposed on *Shariah* compliant portfolios, can be effective in controlling systematic risk. These findings have important implications for investors, the stability of the stock market as well as for regulators. For example, regulators, should be able to develop necessary structures and standards for reducing excessive debt in the stock market. Sorwar et al (2016)'s empirical evidence on the market risk profiles of Islamic and conventional banks provides some interesting implications. One of these implications is that the inclusion of Islamic banks within asset portfolios may mitigate potential risk. In addition, regulators such as the Basel committee should consider the expected shortfall measure of risk for Islamic banks in comparison to the current Value at Risk methodology which over-estimates the market risk of Islamic banks. Saeed and Izzeldin (2016)'s empirical evidence that IBs increased profit efficiency is associated with improved financial stability, and provides an early warning mechanism for investors and stakeholders. Abdelsalam et al (2016)'s study on earning management and conservatism of both Islamic and conventional banks highlights the impact of informal institutions such as religiosity as an additional control mechanism on banks reporting behavior. Their results provide motivation for extending future research on testing the impact of other types of religiosity such as geographic religiosity on banks reporting and other behavioral decisions. In addition, regulators should account for the relationship between religiosity and financial reporting quality when attempting to regulate the global banking industry.

Onder (2016) proposed a model of asset-backed contracts, which is currently being widely practiced in Islamic finance, and provides a resolution to deal with the litigation of sovereign debt defaults.

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